

THE WHITE HOUSE
WASHINGTON

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CABINET AFFAIRS STAFFING MEMORANDUM

Date: 2/21/84 **Number:** 168917CA **Due By:** _____

Subject: Cabinet Council on Economic Affairs - Thursday, February 23, 1984

8:45 a.m. - Roosevelt Room

TOPIC: TMS

ALL CABINET MEMBERS	Action	FYI		Action	FYI
Vice President	<input checked="" type="checkbox"/>	<input type="checkbox"/>	CEA	<input checked="" type="checkbox"/>	<input type="checkbox"/>
State	<input checked="" type="checkbox"/>	<input type="checkbox"/>	CEQ	<input type="checkbox"/>	<input type="checkbox"/>
Treasury	<input checked="" type="checkbox"/>	<input type="checkbox"/>	OSTP	<input type="checkbox"/>	<input type="checkbox"/>
Defense	<input checked="" type="checkbox"/>	<input type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
Attorney General	<input type="checkbox"/>	<input checked="" type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
Interior	<input type="checkbox"/>	<input checked="" type="checkbox"/>			
Agriculture	<input checked="" type="checkbox"/>	<input type="checkbox"/>	Baker	<input checked="" type="checkbox"/>	<input type="checkbox"/>
Commerce	<input checked="" type="checkbox"/>	<input type="checkbox"/>	Deaver	<input type="checkbox"/>	<input checked="" type="checkbox"/>
Labor	<input checked="" type="checkbox"/>	<input type="checkbox"/>	Darman (For WH Staffing)	<input checked="" type="checkbox"/>	<input type="checkbox"/>
HHS	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	Jenkins	<input type="checkbox"/>	<input checked="" type="checkbox"/>
HUD	<input checked="" type="checkbox"/>	<input type="checkbox"/>	McFarlane	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
Transportation	<input checked="" type="checkbox"/>	<input type="checkbox"/>	Svahn	<input checked="" type="checkbox"/>	<input type="checkbox"/>
Energy	<input type="checkbox"/>	<input checked="" type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
Education	<input type="checkbox"/>	<input checked="" type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
Counsellor	<input checked="" type="checkbox"/>	<input type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
OMB	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
CIA	<input type="checkbox"/>	<input checked="" type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
UN	<input type="checkbox"/>	<input checked="" type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
USTR	<input checked="" type="checkbox"/>	<input type="checkbox"/>			
GSA	<input type="checkbox"/>	<input type="checkbox"/>	CCCT/Gunn	<input type="checkbox"/>	<input type="checkbox"/>
EPA	<input type="checkbox"/>	<input type="checkbox"/>	CCEA/Porter	<input checked="" type="checkbox"/>	<input type="checkbox"/>
OPM	<input type="checkbox"/>	<input type="checkbox"/>	CCFA/	<input type="checkbox"/>	<input type="checkbox"/>
VA	<input type="checkbox"/>	<input type="checkbox"/>	CCHR/Simmons	<input type="checkbox"/>	<input type="checkbox"/>
SBA	<input type="checkbox"/>	<input type="checkbox"/>	CCLP/Uhlmann	<input type="checkbox"/>	<input type="checkbox"/>
			CCMA/Bledsoe	<input type="checkbox"/>	<input type="checkbox"/>
			CCNRE/	<input type="checkbox"/>	<input type="checkbox"/>

REMARKS:

The Cabinet Council on Economic Affairs will meet on Thursday, February 23, 1984 at 8:45 a.m. in the Roosevelt Room.

The agenda and background paper are attached.

RETURN TO:

☐ Craig L. Fuller
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THE WHITE HOUSE

WASHINGTON

February 21, 1984

MEMORANDUM FOR THE CABINET COUNCIL ON ECONOMIC AFFAIRS

FROM: ROGER B. PORTER *RBP*
SUBJECT: Agenda and Paper for the February 23 Meeting

The agenda and paper for the February 23 meeting of the Cabinet Council on Economic Affairs are attached. The meeting is scheduled for 8:45 a.m. in the Roosevelt Room.

The Council will consider the report of the Working Group on Federal Credit Policy regarding the trust for investment in mortgages (TIMs) tax legislation drafted by the Department of the Treasury. Several options on the treatment of builder bonds are presented for the Council's consideration. A paper prepared by the Working Group is attached.

Attachments

THE WHITE HOUSE
WASHINGTON

CABINET COUNCIL ON ECONOMIC AFFAIRS

February 23, 1984

8:45 a.m.

Roosevelt Room

AGENDA

1. Report of the Working Group on Federal Credit Policy
(CM # 113)



EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503

February 21, 1984

MEMORANDUM FOR THE CABINET COUNCIL ON ECONOMIC AFFAIRS

FROM: WORKING GROUP ON CREDIT POLICY (Ballentine) *JB*

SUBJECT: BUILDER BONDS AND THE TIMs LEGISLATION

The Goal of the TIMs Legislation

Over the past three years, the Administration has made a strong commitment to control the growth of Federal credit, including the credit of government-sponsored enterprises. The Trusts for Investments in Mortgages (TIMs) legislation furthers this goal by encouraging greater private, as opposed to Federal, secondary mortgage activity.

Initially, the TIMs legislation had two elements that contributed to limiting Federal credit. The first of these is still in the legislation; it eliminates barriers to private issuers of mortgage-backed securities so that those securities can be structured similar to corporate debt. This is done by allowing the trust that holds the mortgage collateral to issue multiple classes of securities and to reinvest any prepayments on the underlying mortgages (rather than being forced to pay the prepayments to the investors immediately) without incurring taxes at the trust level. Thus, a trust can be set up that (1) holds mortgages as collateral, (2) issues short-term and long-term securities, (3) actively manages its portfolio in the sense of reinvesting prepayments on the mortgages, and (4) does not pay taxes at the trust level.

The second element of the initial TIMs proposal eliminated some of the ties that FNMA and FHLMC have with the Federal government. Due to strong indications from Congress that no such direct privatization proposals would be considered and that inclusion of such in the TIMs proposal would jeopardize the whole legislation, the CCEA agreed on November 1, 1983 to eliminate direct privatization proposals from the legislation.

As pointed out in the November 1 CCEA decision memorandum on TIMs, "only those proposals that shrink or limit future growth of the government-insured or conforming segments of the secondary mortgage market can fulfill the Administration's commitment to control the growth of Federal credit." With the removal of the direct privatization proposals from the legislation, this goal is achieved only by prohibiting FNMA and FHLMC access to TIMs-like transactions (including, prospectively, TIMs-like transactions that FHLMC has already engaged in), while allowing the private sector access to TIMs. This will induce the private secondary mortgage market to grow relative to the Federally sponsored agencies. Not only is such a development desirable by itself, but it may also make direct privatization efforts politically more acceptable in the future, since a larger private sector will have developed a track record in serving the secondary mortgage market.

For these reasons, last November the CCEA decided to endorse TIMs tax legislation that does not allow Federally sponsored agencies (FNMA, FHLMC, or GNMA) to use TIMs or TIMs-like instruments or allow their securities to be used as collateral for privately issued TIMs. However, the restrictions against FNMA and FHLMC have raised a peripheral problem that requires the attention of the CCEA.

Builder Bonds

Builder bonds are bonds issued by builders' financial subsidiaries collateralized by mortgages on homes the builder has sold. In many cases the mortgages are VA or FHA mortgages for which the builder has obtained an additional GNMA guarantee. With a GNMA guarantee on the mortgage collateral, the builder can issue AAA rated bonds.

Builder bonds have been used for less than two years, but their use is growing rapidly. Builder bonds allow builders to obtain the cash from a home sale through the bond backed by the home mortgage while deferring the income tax on the home sale. This results in a very large tax saving. Due to the tax saving, builder bonds, whether backed by GNMA guarantees or by private mortgage insurance, are a very profitable financing technique.

Since builders can issue multiple classes of bonds backed by the mortgage pool and since the builder will reinvest any prepayment on the mortgages and not pass the prepayment directly to bondholders, builder bonds qualify as TIMs-like securities. Thus, the CCEA decision on November 1 would prohibit builder bonds from being backed by GNMA, FNMA or FHLMC securities.

Since such a prohibition will be very controversial and since it was not discussed separately at the November meeting, the Working Group is presenting four options with regard to the treatment of builder bonds in the TIMs legislation. (In all cases builder bonds can be issued if they are not backed by agency securities.)

Before presenting the options, a brief review of the advantages a TIMs has will be useful. A TIMs has two principal advantages: it can issue multiple classes of securities and it can manage the trust actively in the sense that it can invest prepayments on the mortgages held as collateral. Of the two TIMs advantages, issuing multiple classes of securities is more valuable than active management.

The four options, along with a brief discussion of the advantages and disadvantages of each, are listed below:

OPTION 1:

Deny TIMs-like arrangements for builder bonds if agency securities are used as collateral. (This is the rule for nonbuilder bond deals including FHLMC's CMO deals, and is consistent with the CCEA decision of November 1.)

Discussion

This option is consistent with the basic thrust behind the TIMs legislation in that it prevents TIMs-like transactions from benefitting from a Federal guarantee. However, this option may make builder bonds much less attractive for builders, particularly small builders that find it expensive to purchase private mortgage insurance to insure the collateral for their builder bonds.

OPTION 2

Allow agency securities to be used as collateral in single class builder bonds that involve active management of prepayments, but do not allow multiple classes of builder bonds with agency securities as collateral.

Discussion

Many of the builder bond deals that have been completed involved only a single class of security, thus this option would allow builders to continue to arrange deals similar to many that they have completed. The ability to issue a multiple class of securities backed by a pool of mortgages is, however, generally recognized to be more valuable than the active management role in a TIMs. Thus, this option prohibits the most valuable TIMs attributes to builders.

OPTION 3

Allow both TIMs advantages (multiple classes of securities and active management) to builder bonds backed by GNMA securities, but only allow single class builder bonds if backed by FNMA or FHLMC securities.

Discussion

A principal short-term goal of credit policy in the housing area has been to enhance the competitive position of the private market relative to FNMA and FHLMC. GNMA is a more targeted housing agency than those two, and is under more direct Federal control than they are. Nonetheless, distinguishing between GNMA securities and FNMA or FHLMC securities is arbitrary and it will be difficult to defend that distinction.

OPTION 4

Allow full TIMs advantages for agency-backed builder bonds.

Discussion

This option will leave builder bonds unaffected by the TIMS legislation. It will, however, allow the full combination of TIMs advantages with the implicit Federal guarantee that comes from agency backing, but the legislation will still prohibit more direct agency access to TIMs advantages.

There is another disadvantage that applies to options 2, 3 and 4, although most strongly to option 4. The savings and loan industry apparently sees builder bonds as a threat. The tax advantages of builder bonds are so great that builders may seek to originate the mortgages for all sales, thus limiting savings and loan business. The savings and loan industry may oppose provisions that relieve builder bonds from the restrictions in the legislation for other transactions (options 2-4).